Dark Horse Securities Inc. Equity Research

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Software & IT Consulting

CGI Group

(GIB.A- TSX)

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Stock Rating: Underperform

Recommendation: SELL

Country: Canada

Key Indices: TSX, NYSE

Price at October 21, 2014 (CAD)	$37.56
Previous Close	$36.95
Target Price 12 month.	$32.30
52- week range	$32.71-$41.47

Market Capitalization (MM)	$10,420
Shares Outstanding (MM)	277.52
Float (MM)	275.12
Dividend/ Div Yield	NM
LT Debt/ Capital	27.1%
Total Debt (MM)*	$1,981
5Y Beta (monthly)	0.30
90 Day Avg Vol (MM)	0.63
P/E (12 month trailing)	15.19x
EV/EBITDA*	8.7x

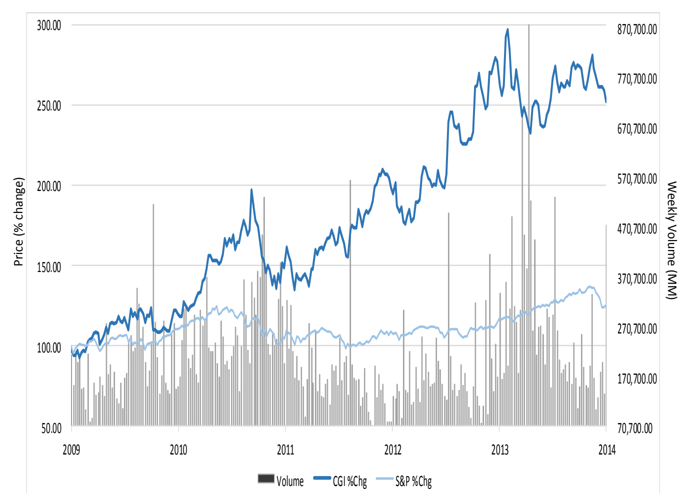
**figures as of Q3/2014*
Source: Reuters

	Q3/2014A	Q2/2014A	Q1/2014A
Total Revenue	$2,667	$2,704	$2,645
EBITDA	$455	$459	$414
EBIT	$347	$342	$303
EPS	$0.71	$0.73	$0.60

Poor organic growth, revenue headwind and undesirable business mix

- **CGI reported In-line Q3 results, but momentum will likely reverse.** CGI will report Q4 results on November 13. We expect a weak Q4 from CGI consistent with our view that CGI will continue to face headwinds from revenue growth and EBIT margins.
- **Significant revenue headwinds from all areas.** CGI's business mix has a high concentration in government contracts. With 2015 government spending in IT down globally, 26% of CGI's business will face increasing revenue pressure. Europe is slowing and CGI's acquisition of Logica has boosted its book to bill ratio in Europe but in an undesirable segment. Splitting these revenue streams, the two lines of business are actually showing very little growth.
- **Fierce competition from global firms and emerging Indian firms.** IBM reported disappointing Q3 with EPS missing average consensus and lowering their 2015 earning forecast. Global IT services are likely to see pressures from smaller and lower margin contracts while operating under intense competition.
- **Is the industry trend of acquisition as part of the business model sustainable into the future?** In the past 5 years, 80% of all industry growth has come from acquisitions. As consolidation continues along with looming rate hike that will increase cost of capital, we ask if this strategy can be the sole driver of value going forward.
- **Actual EBIT margins do not look attractive.** While CGI's non-GAAP measure of adjusted EBIT looks healthy at 10%, actual EBIT margin is around 7%. We believe this is a more relevant measure.

CGI and S&P/TSX Performance



*Figures are rebased to 100 dollars as at Oct 7, 2009

Recommendation

We recommend a sell on CGI Group with a 12 month target price of $32.30. We believe that CGI will face continued headwinds on revenue growth and EBIT margins operating under uncertain macro environment and intense competitions from global competitors. CGI's lack of ability to generate organic growth is of significant concern. Our target price is based on a FY2015 EBITDA multiple of 8.73x and including restructuring cost into our forecast model.

**Unless otherwise denoted, all figures are shown in $CAD*

Company Profile

CGI Group is Canada's largest IT services company. The company is headquartered in Montreal, Quebec and has 68,000 employees around the globe. CGI delivers IT consulting and systems integration services, and outsourcing solutions onsite at client premises and/or remotely through the company's 24 global delivery centres located in North America, Europe and India. CGI completed the acquisition of Logica in August 2012, becoming a major global IT services vendor.

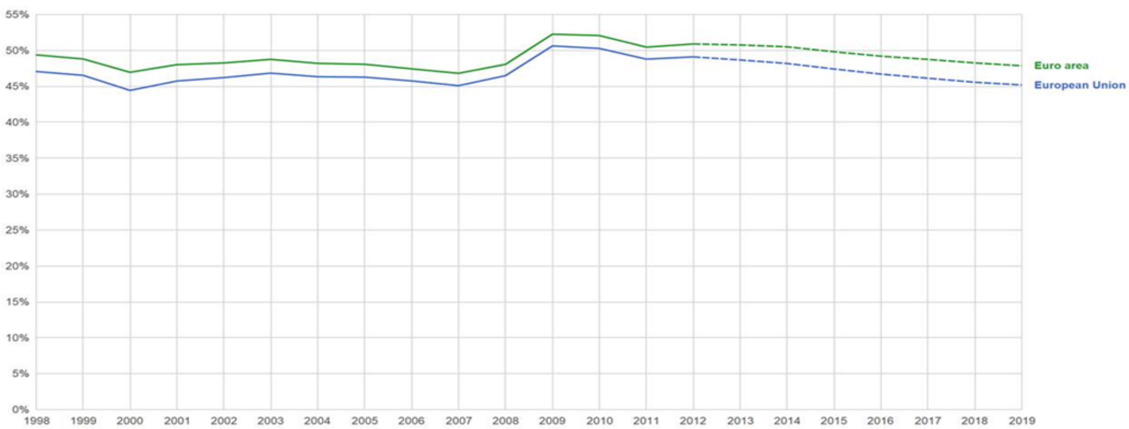
Investment Thesis

We expect CGI's top line revenue to deteriorate as a result of stagnant growth in the Euro zone and decreasing government spending across the globe. Though CGI has a strong cash position, we view CGI's "build-and-buy" strategy as unsustainable given the amount of consolidation that has already taken place in the industry. The lack of organic growth compounded by the uncertainty of future acquisition leads us to believe that CGI should be trading at a discount compared to its industry peers. With marginal increases of book-to bill from European operations, we believe the value added by the Logica acquisition is fully priced in. We believe CGI is currently overvalued and further value depreciation is expected with slower growth going forward.

Significant Headwinds From All Areas

With CGI's acquisition of Logica in 2012, they have created significant business exposure in the Euro zone. Looking at Fiscal 2013 results, 54% of its revenue comes from Europe. Spending as a % of GDP in Europe has declined steadily and forward looking projections continue this trend [Exhibit 1].

Exhibit 1: General government total expenditure (% of GDP)



Source: IMF

We point to Q2 and Q3 2014 performance in Europe as an indicator of operational headwinds. The firm's non-GAAP measure of adjusted EBIT in Nordic regions and France (areas where we expect the most economic headwind) decreased sharply [Exhibit 2]. We look to these tightening margins as an indicator that there will be increasing revenue pressure from decreasing government expenditure. Relative to the rest of the Eurozone, UK is the only significant economy where CGI has exposure to that has steady amount of IT spending, representing only 11% of the overall business by revenue.

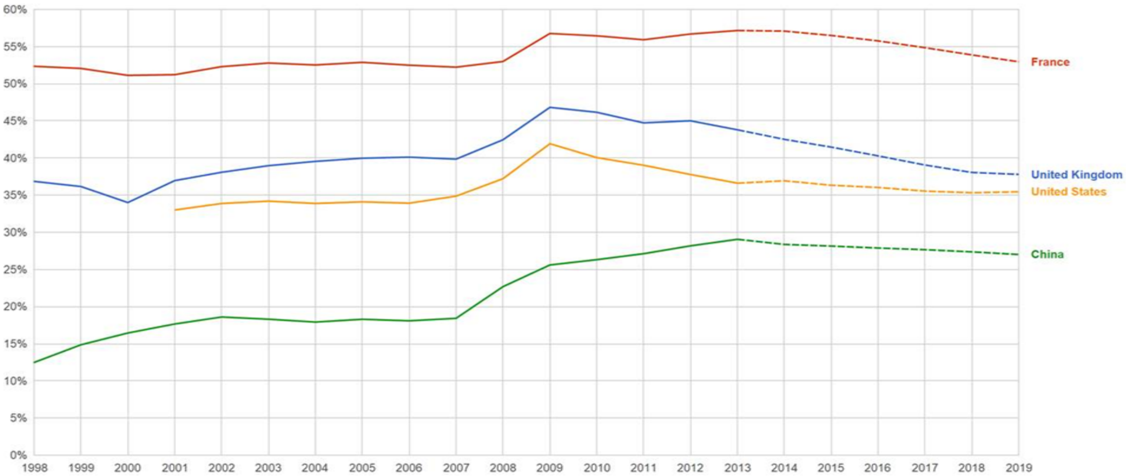
Exhibit 2: Adj. EBIT broken down by CGI and Logica

	12-Dec	13-Mar	13-Jun	13-Sep	13-Dec	14-Mar	14-Jun
Nordic	3.2%	7.6%	7.6%	10.0%	9.0%	11.4%	9.1%
France	4.1%	9.6%	8.9%	12.3%	10.8%	17.4%	5.5%
UK	3.1%	10.6%	10.0%	11.8%	7.4%	11.5%	13.1%
Central/Eastern Europe	5.7%	5.0%	7.3%	8.8%	10.5%	9.9%	9.9%
APAC	9.2%	11.9%	12.7%	14.2%	11.2%	14.5%	14.8%
Logica Margins	**4.3%**	**8.5%**	**8.7%**	**10.9%**	**9.5%**	**12.7%**	**9.7%**
Canada	19.6%	17.6%	19.2%	19.7%	21.4%	22.3%	21.8%
US	10.5%	10.0%	12.3%	12.2%	9.8%	6.2%	14.6%
CGI Margins	**8.3%**	**10.4%**	**11.3%**	**12.7%**	**11.5%**	**12.6%**	**12.8%**

Source: Company Reports

With anticipation of slower European growth, we turn our attention to the US which represents 25% of CGI's revenues. While recovery there appears to be on track, the 2015 US fiscal budget actually shows a spending cut in IT of 3%. As well, sequestration will trigger automatic future government spending cuts. After Canada and the Asia Pacific region, the US business is the most attractive in terms of Adj. EBIT at 14.6%. With spending cuts in the US, we are expecting tightening margin in this line of business as well [Exhibit 3].

Exhibit 3: General government total expenditure (% of GDP)



Source: IMF

Keep in mind that increasing competition from abroad, especially in India, could continue to drive down margins. In fact, the Indian peer set has a higher EBITDA margin relative to CGI and appears better positioned to absorb a global downturn in IT spending [Exhibit 4]. In summation, almost 80% of CGI's revenue is exposed to an economy which is either slowing or slowing its spending in IT. Coupled with a competitive landscape, we expect revenue growth and projections to be relatively flat going forward.

Exhibit 4: Margins Difference between CGI and Indian Competitors

Company	EBITDA Margin
Cognizant	20.40%
Infosys	27.00%
TCS	29.50%
Wipro	23.40%
CGI	17.06%

Figures Based on Most Recent Quarter

Not a Compelling Growth Story

We do not share with the same views as the street when it comes to CGI's growth potential. It is our opinion that CGI is artificially boosting its growth through expensive acquisitions. In fact, for the last 5 years, CGI spent the most amount of money on the least amount of acquisitions, leaving the business mix overly concentrated. We are concerned, with the downward trend in the macro environment, that CGI's strategy of placing all its eggs in one basket will be dangerous. As well, with a looming rate hike in the US, we are concerned that acquisition targets will not only be harder to find, they will also be tougher to afford.

In addition, CGI does not appear to be able to deliver the most value on these investments compared to its peer set. Looking at the DuPont analysis provided in [Exhibit 5], the company's 2013 return on equity is actually among the lowest in the Canadian peer group.

Exhibit 5: CGI Acquisition Summary from 2008 to 2013

	CGI	Constellation	MDA	Open Text	Enghouse
Number of Acquisitions	2	121	2	15	12
Cumulative Expenditure (MM)	$3,965	$830	$1,774	$109	$1,024
2013 Return on Equity Figures					
Net Profit / Sales	4.5%	8%	6%	11%	14%
Sales / Assets	93%	79%	70%	51%	65%
Assets / Equity	268%	578%	325%	199%	152%
Net Profit / Equity	**11.22%**	**36.53%**	**13.65%**	**11.16%**	**13.83%**

Source: Reuters

Using geographic region as a proxy for revenue by Logica and CGI, we can actually see that since the acquisition, CGI revenue growth is basically stagnant while Logica growth shows volatility [Exhibit 6]. Combined with our macro views, we are deeply concerned with the growth prospects of the firm and the ability of management to strategically target value-adding firms. Higher cost of acquisitions, coupled with lower ability to generate profit from these acquisitions compared to the industry average, are not rosy signs.

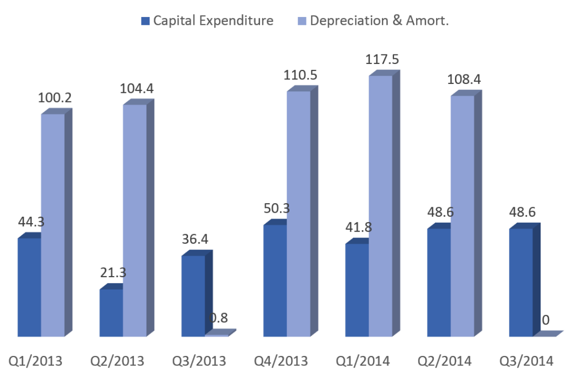
Exhibit 6: Total Revenue Broken Down by CGI and Logica

C$ (millions)	12-Dec	13-Mar	13-Jun	13-Sep	13-Dec	14-Mar	14-Jun
Nordic	$534	$511	$529	$437	$549	$565	$530
France	$321	$330	$337	$285	$332	$359	$331
UK	$293	$278	$283	$304	$287	$337	$338
Central/Eastern Europe	$263	$254	$242	$246	$269	$270	$270
APAC	$117	$112	$111	$99	$102	$106	$106
Logica Revenue	**$1,528**	**$1,485**	**$1,502**	**$1,371**	**$1,539**	**$1,637**	**$1,575**
Canada	$428	$420	$430	$408	$421	$422	$413
US	$577	$621	$635	$679	$686	$645	$679
CGI Revenue	**$1,005**	**$1,041**	**$1,065**	**$1,087**	**$1,107**	**$1,067**	**$1,092**
Total Revenue	$2,533	$2,526	$2,567	$2,458	$2,646	$2,704	$2,667
CGI Q/Q Growth	3.58%	2.31%	2.07%	1.84%	-3.61%	2.34%	-
Logica Q/Q Growth	-2.81%	1.14%	-8.72%	12.25%	6.37%	-3.79%	-
Total Q/Q Growth	-0.28%	1.62%	-4.25%	7.65%	2.19%	-1.37%	-

Source: Company Reports

We are also concerned with the company's ability to find avenues of organic growth. Comparing the schedule of historical capital expenditure to depreciation, capital expenditure as a % of depreciation is very low, suggesting that CGI is not replacing antiquated fixed assets with new ones [Exhibit 7]. This points to low organic growth opportunities going forward. We believe that CGI's model of "build" and "buy" is heavily focused on the "buy" as opposed to the "build". With the increasingly tense competition and costs in the "buy" method, we do not view CGI as a particularly compelling growth story.

Exhibit 7: CGI Capex vs. Depreciation & Amort. ($MM)



Source: Capital IQ

In addition, we argue CGI's non-GAAP measure of Adj. EBIT to view its margins is not the relevant measure. Having established that the company's revenue has only grown in proportion to the revenue of the newly acquired company, actual EBIT is only growing as a result of these acquisitions. Acquisitions are part of the business model. By extension, the integration and restructuring costs that come with it must also be part of the business expenses and should not be considered as one time expenses. Following this logic, the company's EBIT margin (including integration costs) is the relevant measure of operating performance. These margins are even smaller and below average compared to peer sets [Exhibit 8]. Hence, we will be including restructuring costs in our forward looking EBIT projections for valuations purposes.

Exhibit 8: EBIT Margins

Year	CGI	Accenture	IBM	Constellation	MDA	Open Text	Enghouse
2011	13.19%	13.61%	20.03%	10.60%	23.50%	12.66%	15.54%
2012	6.39%	13.90%	21.40%	10.45%	15.64%	14.32%	16.31%
2013	7.35%	15.19%	19.98%	10.14%	9.77%	18.74%	13.98%

Source: Company Reports

Downward trend of Book to Bill

CGI's book to bill in Q3 declined to 1.014 as companies are looking for less expensive and shorter contracts. Regulations in US and Europe are also extending contract negotiation periods. The continued downtrend of book to bill ratio reflects the challenging landscape CGI is operating in and will negatively impact the already slow top line growth of CGI [Exhibit 9]. CGI did grow their book to bill in Europe for Q3. However, we would like to reiterate our bearish outlook on Europe. This increasing exposure to Europe is undesirable in our opinion.

Exhibit 9: Bookings vs. Book to Bill

Peer Analysis

IBM

IBM's (IBM-NYSE) FQ3 results, released on October 20, shocked the street this week by posting EPS of $3.68, heavily missing the consensus mark of $4.32. Revenue was down 4% year over year to $22.4 billion.

- Service revenue was down 2.2% year over year while its technology and systems arms were down 2.9% and 15% year over year. Management cited weakness in the Europe/Middle East/Africa region as key factors.
- Management no longer expects to deliver "at least $20 Operating EPS" in 2015 and expects to deliver new guidance in January.

This provides evidence to our theory of deteriorating conditions in Europe.

Computer Science Corp

Computer Science Corp (CSC-NYSE) released FQ1 results on August 7, posting EPS of $1.03 in line with expectations.

- Year over year Q1 revenue was down slightly by 1% to $3.24 billion. Specifically, their revenue from the North America public sector (US Department of Defense contracts) was down 3.3%.
- Overall bookings were down 3.5% year over year to $2.7 billion with the North America public sector down to $0.3 billion.

This also provides evidence to our thesis of declining revenues in the US government contract space.

Exhibit 10: Peers Multiple

Company	Ticker	Currency	P/E FY14	EV/EBITDA FY14	P/E FY15	EV/EBITDA FY15
CGI	GIB.A	CAD	13.70	8.11	11.92	7.70
Accenture	CAN	USD	18.01	9.97	16.36	9.40
IBM	IBM	USD	10.02	8.18	9.52	7.78
Cognizant	CTSH	USD	18.18	11.21	16.07	9.81
Infosys	INFY	INR	17.91	12.01	17.81	12.51
Computer Sciences Corp	CSC	USD	13.90	4.45	13.23	4.16
Peer Average			15.60	9.16	14.60	8.73

Source: Bloomberg

Valuation

We look to these peer sets to provide guidance for the growth of the industry, and more specifically, the comparative growth of CGI going forward. With the restructuring costs and the headwinds being already experienced by CGI's peers, we forecast EBITDA for FY2015 to be roughly $1,360 million. Applying an EV/EBITDA multiple of 8.73x, determined by the average of our peer sets [Exhibit 10], we arrive at a price of $32.30. Based on our sensitivity analysis, our expected price range is from $31.80 to $33.36.

Key Risks to Valuation

We view the following risks to our price target of $32.30

- Unexpected pickup in economic conditions in Europe
- Greater than expected demand in Asia-Pacific
- Further deterioration of the Canadian dollar relative to the US dollar, making CGI's services more competitive in the market